

in the future). In addition, the new products for the individual market segment will be available beginning January 1, 2001.

Outside of California, 3Q00 plan enrollment grew by approximately 5% (or about 140,000 members) versus the same period last year – to 2.2 million enrollees. The company experienced a modest increase in non-California large-group membership during 3Q00 – the first quarterly increase since the company began repricing this book for more adequate levels of profitability. The company's individual and small employer segment outside of California experienced robust growth during the quarter, adding 35,000 members – a 12% increase from last year. WellPoint also recently introduced new small group product designs and expects to see growth in sales and profitability in 2001 coming from these new products. Membership in proprietary networks also continues to grow as the company adds enrollees in targeted geographies and gradually shifts members away from affiliate network and non-network areas. As a result, year-over-year enrollment in the company's proprietary networks grew to 6.0 million members – up 8% from the same period last year. Members within the company's proprietary network now represent 77.7% of the company's total enrollment (up from 77.5% in 2Q00). During the quarterly conference call, management indicated that it anticipates overall membership growth (inside and outside of California) to be in the mid-single digits, driven by the economic environment, competitors' actions, and the success of the company's new individual and small group products.

The company is also targeting the individual uninsured population as a source of membership growth. In WellPoint's targeted geographies (California, Texas, Georgia and the Midwest), there are approximately 6.5 million people with income levels that are 200% of poverty and that have no health insurance coverage. WellPoint believes that its redesigned product will likely be attractive to this segment of the population. This innovative product includes higher patient cost sharing (allows WellPoint to address the sensitive issue of high premiums, and thus keep premiums more affordable) and first dollar coverage for pharmaceuticals and laboratory costs, as well as features such as allowing four yearly physician visits for children and two visits for adults with only a \$20 copay. Like some of WellPoint's other products, this product carries \$5 million in lifetime health coverage. Most importantly, this product is priced 50% lower than the traditional product. Management expects these products to generate lower MLRs because of more effective self-management of health care and increased cost sharing by the member.

During 3Q00, premiums rose approximately 7% in California and the company expects net premium yields to remain up in that range in 4Q00. For 2001, premium increases are likely to run in the 7.5%-8% range (maybe slightly higher depending on benefit selection actions made by customers throughout the year in open enrollment). Outside of California, the company continued to realize premium increases in the 8%-11% range, depending on geography and product type. This level of pricing is also expected to continue in 4Q00, with a modest acceleration in trend expected for 2001. With respect to cost trends, management indicated that medical cost inflation in California during 3Q00 was about 6.0% – in line with expectations. In 2001, the company anticipates that this trend should rise to the 6.5%-7.5% range. Outside of California, the company saw medical cost increases of 6%-8%.



The company's balance sheet remains quite strong, in our view. At quarter-end, WellPoint's long-term debt remained relatively flat at \$400.1 million (versus \$399.4 million at the end of 2Q00). However, the company's long-term debt to capitalization ratio improved to 21.3% compared with 22.3% at June 30, 2000. Cash and investments increased to \$3.5 billion from \$3.3 billion at the end of 2Q00. We continue to believe that the company's debt level is well inside of management's comfort levels. Additionally, given the significant levels of cash and investments that the company has on hand, we estimate WellPoint has more than enough excess cash to completely eliminate debt by year end, if desired. WellPoint's operating cash flow was also strong in the quarter, totaling approximately \$150 million. Regarding share repurchase activities, the company bought back 602,800 shares of its common stock from the California Healthcare Foundation during the quarter, for \$52.4 million or about \$87 per share. Over the past two years, the company has spent approximately \$659 million to repurchase 10.3 million shares (or almost 15% of the company's share base). Company management stated that it remains committed to the share repurchase program and will base future activity on cash flow generation, as well as alternative investment opportunities.

Medical claims payable were \$1.4 billion at September 30, 2000. Consolidated days in medical claims payable increased by 3.1 days – to 73.0 days from 69.9 days at the end of 2Q00 (and versus 72.9 days posted at December 31, 1999). Management commented that the sequential rise in days in claims payable was due to: 1) a change in the mix of the company's insured business to products and geographies that have a higher days in claims payable trend (this increased the metric by 0.7 days), 2) a reduction of \$10 million in claims payables associated with the timing of bi-weekly pharmacy claims payments (this reduced claims by 0.8 days), and 3) as a result, nearly 100% of the increase in medical days payable was due to higher IBNR accruals. This increase in IBNR accruals was due to lower paid claims during the quarter and actuarial conservatism associated with the new products that were introduced in 3Q00.

During the 3Q00 conference call, Cerulean's third-quarter results were also discussed. Premium revenue in the quarter grew 27% year over year to \$474 million, reflecting solid membership growth and strong pricing trends. Total revenue rose 26% from last year – to \$521.9 million. Cerulean's MLR for 3Q00 was 86.9% compared with an MLR of 87.9% in the same quarter last year. Total membership was 1.8 million at the end of the quarter, up 10% over last year. Insured membership of 957,000 rose 17% versus 3Q99. Cerulean's days in claims payable rose by two days on a sequential basis to 54 days. For 2001, overall membership growth is anticipated to be up 5% from 1999 levels, while insured membership is expected to grow 7%-8%. Premium increases are expected to rise in the low-double-digit range in 2001, after benefit design changes and product mix changes. Management currently expects the acquisition to close in December. After the closing, WellPoint will immediately begin to focus on integrating the data of the two companies, which it believes is most important (especially enrollment, claims, and administrative expense data), and is targeting to be done with this phase of the integration by the end of the first month after the transaction is completed.

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Deutsche Banc Alex. Brown

US
Managed Care

Deutsche Bank



November 8, 2000

Trigon Healthcare, Inc.

Strong 3Q00 Earnings Results — Raised Price
Target and Maintained Strong Buy Rating

Rating Remains
Strong Buy

Price
US\$69 1/16

Exchange: Ticker
NYSE: TGH

| FY: (Dec.) | 1Q | 2Q | 3Q | 4Q | FY EPS | CY EPS | CY P/E | Rev MM |
|------------|--------|--------|--------|--------|-----------|-----------|-----------|-----------|
| 1999A | \$0.43 | \$0.49 | \$0.54 | \$0.62 | \$2.09 | \$2.09 | 28.4 | \$2,368 |
| 2000E | 0.70A | 0.80A | 0.92A | 0.84 | 3.26 | 3.26 | 21.2 | 2,629 |
| 2001E | NE | NE | NE | NE | 3.77 | 3.77 | 18.3 | 2,967 |

Source: Deutsche Banc Alex. Brown estimates and company information

| | | | |
|--------------------------|-----------|---------------------------|-------------|
| 52-Week Range: | \$76-\$26 | ROE: | 8.0% |
| Shares Outstanding: (MM) | 38.6 | LT Debt: (MM) | \$275.2 |
| Market Cap: (MM) | \$2,659 | LT Debt/Total Cap: | 21.7% |
| Float: (MM) | 37.1 | Div./Yield: | \$0.00/0.0% |
| Avg. Daily Volume: | 272,800 | 3- to 5-Year Growth Rate: | 17% |
| S&P 500: | 1,409.28 | CY01E P/E-to-Growth: | 1.1x |

- Trigon Healthcare posted very strong 3Q00 results. EPS (excluding realized gains and losses) rose more than 70% from last year and 15% sequentially to \$0.92, \$0.03 above the consensus estimate and \$0.01 above our estimate.
- Total revenue increased 12.9% to \$666.5 million. Premium and fee revenue rose 10.7% while investment income grew 16.5% from the year-ago quarter.
- Medical cost inflation was in the 6.5% area while the premium yield trend was 9%. Trigon's Medical Loss Ratio (MLR) improved to 79.4% from 81.1% in both 3Q99 and 2Q00. We project that the company's MLR will remain one of the lowest in the industry, improving to 81.1% in 2000 and 81.0% in 2001.
- We believe the company's fundamentals will remain strong and the competitive environment in Virginia will remain stable, presenting opportunities for Trigon. Following Trigon's 3Q00 conference call, we raised our 2000 EPS estimate to \$3.26 from \$3.25 and we raised our 2001 estimate to \$3.77 from \$3.75. We also raised our 12- to 18-month price target to \$81, 20x our blended 2001/2002 EPS estimates.

Gary M. Frazier

Edward P. White

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Investment Thesis

Trigon Healthcare has reported earnings at or above consensus expectations in each quarter since going public in January 1997. The company appears to us to be on track to produce margin expansion in 2000 and steady compound annual earnings growth of 17% for the next three to five years. Trigon's MLR is one of the best in the industry and it continues to price its commercial business 50-100 basis points above its medical cost trend. Despite this, the stock currently trades at 18.3x our 2001 estimated EPS. We believe that this company deserves a premium to its peer group owing to its dominant market share in the attractive Virginia market, its track record of earnings consistency, its unmatched physician network and its disciplined underwriting and acquisition strategy. Our 12- to 18-month price target of \$81 is 20x our blended 2001/2002 EPS estimate.

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Details

Trigon Healthcare reported third quarter earnings of \$0.92 per share versus \$0.54 per share in 3Q99 (an increase of 70.4%) — beating the Street's prior consensus expectations of \$0.89 per share and our EPS estimate of \$0.91. Operating income tripled from last year to approximately \$30 million, while combined pretax operating investment income was \$52.9 million — a 39.6% increase over 3Q99. The operating margin in the quarter was 4.7% versus 3.3% last quarter. Trigon has exceeded management's goal of bringing the operating margin to 3.0% by the end of 2000. For the first nine months of 2000, the company's operating margin was 3.7%.

The key drivers of the company's strong results included accelerating enrollment growth trends, stable medical costs, continued premium increases and disciplined control of administrative costs. The commercial business in Virginia posted rate increases in the high single digits to low double digits, along with enrollment growth of 10.6%. In addition, membership in the company's PPO product grew by 31.4% versus 3Q99. Total revenue in the quarter rose 12.9% from last year — to \$666.5 million. Total premium and fee revenue grew by 10.7% to \$633.1 million versus 3Q99. Premium revenue gains were driven by 10.4% commercial revenue growth in Virginia. Investment income of \$29.7 million was up 16.5% versus \$25.5 million in the prior year's quarter.

Membership, MLR and Medical Cost Trends

Virginia fully insured commercial membership rose by 10.6% (excluding Mid-South membership in 3Q99) in the quarter compared with a year ago — to 1.1 million members. Growth in Virginia was driven by a 31.4% increase in PPO enrollment and a 6.9% increase in the Medicaid/Medicare HMO segment. The commercial HMO product increased by only 0.2%, but grew by approximately 8% excluding the loss of 23,000 members from the State of Virginia contract that the company decided not to renew (the company captured back approximately 17,000 of these members in its self-funded product). Total enrollment also includes the addition of approximately 9,000 Medicaid lives purchased from Mid Atlantic Medical in May. Only the company's PAR network product experienced membership declines during the quarter, as expected. Enrollment in self-funded products increased by 6.3% and now represents over 715,000 of the company's total 1.77 million members. Self-funded membership would only have grown approximately 4% if the members captured from the State of Virginia contract are excluded. Management attributes the strong Virginia growth to a favorable cost position, fair pricing and dependable service, as well as an MLR that, according to the company's latest statistics, was 900 basis points below its seven largest competitors.

In 2000, the company will place additional emphasis on e-commerce for brokers, providers and customers, with a goal of increasing the ease of doing business and lowering administrative costs over time. By the end of 3Q00, Trigon was linked with more than 4,000 physicians — which was the company's year-end goal — representing about 15% of the company's inquiry volume. Over time, we believe these e-commerce initiatives should



end goal). The program enables doctors to engage in a full range of administration interactions with Trigon through the Internet. Regarding brokers, the company is on track with the development of e-distribution and sales support tools for brokers and direct sales representatives. These tools will improve efficiencies and information flow, and relationships with key brokers. These two areas, providers and brokers, are areas the company will focus on in 2001. The company anticipates that its SG&A ratio will rise in 4Q00 and 1Q01 and then decline starting in 2Q01. The SG&A ratio is expected to be approximately 12.5% for 2001.

Balance Sheet

Trigon's financial condition remained strong in 3Q00, in our opinion. The company generated \$60 million in cash flow from operations during the quarter versus \$35 million in 2Q99. However, the company posted a cash loss of \$3 million when the impact of a normal settlement agreement payment to the State of Virginia during the quarter is included. The Virginia payment represents the routine annual settlement of cash flow for the state's self-insurance contract. Year to date, the company's operating cash flow totaled approximately \$59 million versus \$122 million in the same period in 1999. The difference is primarily attributable to the run out of the Mid-South liabilities in 2000. At quarter-end, cash and investments totaled \$1.8 billion, while long-term debt increased to \$275.2 million as the company issued \$30 million in additional commercial paper in the quarter. In the quarter, the company purchased approximately 75,000 shares of its stock at approximately \$49.70 per share. The company has repurchased approximately 501,000 shares from its second stock repurchase authorization of 3.8 million shares.

Days in claims reserves were 70 days in the quarter flat with 2Q00. This was in line with management's earlier comments that this metric was expected to remain in the 65-70 day range due to the Mid-South run-out of liabilities. Previously, management stated that the eventual run-off of the Mid-South claims should bring days in claims payables down to the upper-60s — a more normalized level.

Legal Proceedings

In June, the company announced that it filed a lawsuit against the IRS for the recovery of federal income tax overpayments for the years 1989-1995. Trigon hopes to recover in excess of \$100 million in cash (\$60 million in cash refunds and \$40 million in interest) and additional tax credits. The issue relates to the initial valuation and deductibility of Trigon's assets when, along with other Blue Cross/Blue Shield plans, it became subject to federal income taxes in 1987. The IRS approached the company with a settlement about two years ago, which Trigon accepted. However, the agreement has been bogged down at the IRS and the company has sued to recover the overpayments. Management has talked to outside experts that believe the company has a solid position. Management can not make any estimates regarding the timing of resolution. A court date is expected in 1Q01 or 2Q01. Regarding the American Chiropractic Association lawsuit, the company said that it has filed motions for dismissal and expects to hear from a judge in December.